

INTER-DEPARTMENT COMMUNICATION

TO	City Council	DATE	March 31, 2006
DEPARTMENT		FROM	Joel D. Pedersen
ATTENTION		DEPARTMENT	City Law
COPIES TO		SUBJECT	Aquila Gas Franchise

Aquila Seeks to extend current Natural Gas Franchise to 12/31/2014.

Aquila operates under a 1994 approved City franchise¹ and the state's Natural Gas Regulation Act² as both a natural gas commodity provider and a regulated local distribution company. Aquila has made a timely filing under the terms of the current franchise to request an 8 year extension. Under Section 9 of the Franchise the extension is available "if [Aquila] can demonstrate it has assisted the City in Meeting the City's objectives of encouraging natural gas competition and ensuring safe, reliable, and low-cost natural gas service." Although, the franchise is technically non-exclusive, the City has always had a single utility for residential natural gas service.

Standard: "encouraging natural gas competition and ensuring safe, reliable, and low-cost natural gas service."

Aquila has submitted a report to "document the progress" made in meeting the stated objectives. According to the franchise, the City is to conduct "an inquiry" and make a determination to grant the extension according to the standard. The inquiry would be satisfied by a public hearing on the attached ordinance and the City's final decision to grant or deny the extension along with the record of accompanying testimony and considerations. The City is also under a general legal guideline to base its decision on the stated objectives. For example, it would not be reasonable for the city to deny the extension on other grounds.

Progress as documented.

Aquila's report – Filed Separately

Regulatory environment – The City is in a different position than in 1994. At that time, there was a significant dust up surrounding two major orders from the Federal Energy Regulatory Commission (FERC) designed to open the natural gas industry to more competition and less regulation, at least at the federal level. As earlier noted, in 2003, the

¹ Ordinance No. 16713 Approved 12/22/1994 as amended by Ordinance No. 17359 Approved 6/25/1998.

² On May 30, 2003, the Nebraska Legislature passed the Natural Gas Regulation Act, providing for regulation of the rates and services of investor-owned natural gas utilities by the Nebraska Public Service Commission ("PSC" or "Commission"), Neb. Rev. Stat. §§ 66-1801 to 66-1857.

state of Nebraska repealed the Municipal Natural Gas Regulation Act in favor of state natural gas rate regulation under the Public Services Commission. Aquila's report broadly concludes that preemption is applicable in many respects due to the new state law. The City does not concede this is correct, but this is not the forum to make that decision anyway. The bottom line is the parties do not need to agree on the level of or preclusive effect of new state law to grant the extension as applied for.

Comparative Rates – The City has long used comparative rates as a touchstone for determining the “low cost” portion of the stated objective. Aquila did not provide comparative rates with its initial report, but has agreed to provide the same covering the years since the franchise approval in 1994 through the current heating season. Any analysis of comparative rates has to acknowledge the consumer's concern for volatility. Volatility in the energy market is nothing new. The NYMEX (New York Mercantile Exchange) http://www.nymex.com/ng_fut_pso.aspx tracks the prices for futures contracts of natural gas. Futures contracts have been a mainstay of the energy commodities market since they were introduced (beginning with heating oil) in the mid 1980's. While trading futures contracts does little to eliminate price volatility, it does provide real time price and supply information. Although the market as it has evolved does introduce other (perhaps extraneous) variables into commodity pricing, the consensus view is those distractions are preferable to prices and supply contracts known only to the buyers and sellers.

Franchise Fee History.

In the same legislation adopting the 1994 franchise, the City also repealed the occupation tax method of collecting the natural gas franchise fee. At the time, the City was concerned that a simple change in business structure would allow the franchise operator to avoid paying occupation tax on the commodity of natural gas – approximately 60% of the billed amounts. More particularly, if Aquila operated solely as a local distribution company, simply charging a fee for others to use their pipes to deliver natural gas, then the City's tax revenues were in jeopardy. In lieu of the occupation tax, the franchise fee used a linear foot charge (similar to our underground cable code) to collect revenue. The fee was designed as a “make whole” provision to replace what was previously collected under the occupation tax. The rate per foot of \$0.39 has not changed, but the growth of the system has increased approximately 22%. (See Attached Chart).

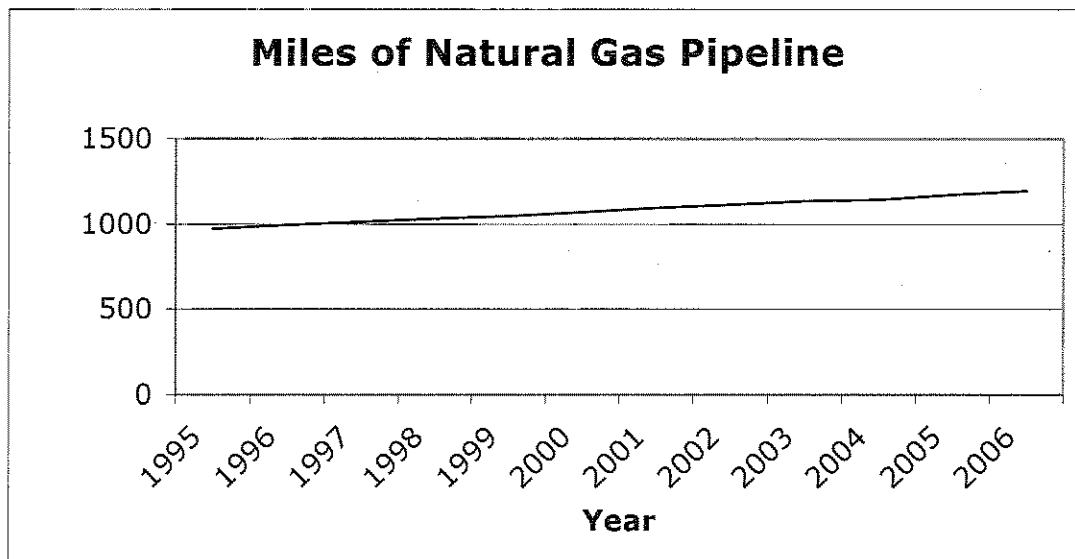
Encouraging Competition.

Aquila has cooperated with the City on some limited efforts for competitive gas supply. The City hired a consultant to assist in pooling natural gas purchases for larger accounts with other public entities with modest success. This experience developed an increasing interest in posting standard transport merchant and customer agreements so that we could effectively interest bidders. It was and remains theoretically possible for Aquila as the “only pipe” available to be in a position to favor one gas supply company over another by varying terms in the merchant agreement. The City was also reminded that bidders should not be able to game the system at the expense of the local distribution company

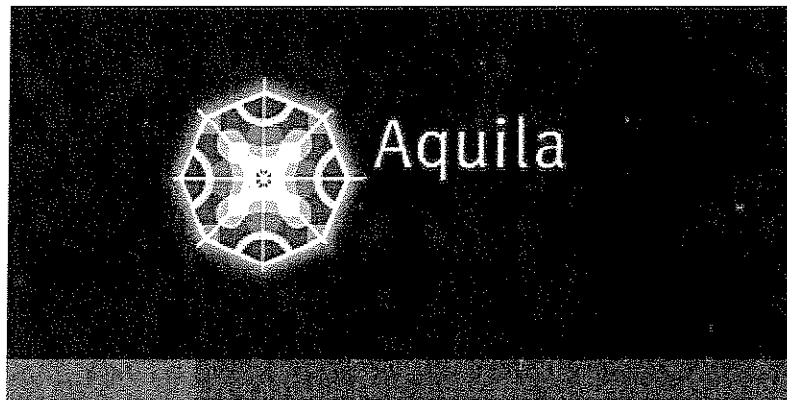
either. Given the new natural gas regulatory framework under the state PSC after LB 790 (2003) the attached ordinance restates a long-standing request to offer commercial class transport customers service under standard merchant agreements and customer verification forms at posted local transportation rates. This is analogous to the benefits of transparency in pipeline contracts and the futures market, and would be helpful to both customers and overall economic development efforts in the City of Lincoln.

Miles of Natural Gas Pipeline

	<u>Miles of Pipeline</u>	<u>Percent of Change</u>	<u>Total Percent of Change</u>
1995	971.25		
1996	996.47	2.60%	
1997	1014.02	1.76%	
1998	1031.95	1.77%	
1999	1047.32	1.49%	
2000	1068.81	2.05%	
2001	1094.92	2.44%	
2002	1113.5	1.70%	
2003	1135.7	1.99%	
2004	1144.24	0.75%	
2005	1173.38	2.55%	
2006	1194.15	1.77%	22.95%



3/23/06



**LINCOLN FRANCHISE
EXTENSION REPORT**

AQUILA, INC.

FEBRUARY 2006

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 - “safe, reliable, low-cost service”

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1. INTRODUCTION

- Franchise language requiring this report
 - “encourage competition”
 - “safe, reliable, low-cost service”

1. INTRODUCTION

This report is filed pursuant to Section 9 of the natural gas franchise granted by the City of Lincoln to Aquila Inc. d/b/a Aquila Networks approved by the City in 1994. Under the franchise the City agrees to grant an extension of the original term of the gas franchise for an additional eight (8) years commencing January 1, 2007 if Aquila files a compliance report after December 31, 2005 and before March 1, 2006 documenting the progress that Aquila has made in meeting the City's objectives of encouraging natural gas competition and ensuring safe, reliable, and low-cost natural gas service. The extended term would end on December 31, 2014. Section 9 of the franchise notes that upon receipt of this report, and after due inquiry of the facts contained herein, the City will consider and thereafter approve the extension based on Aquila's compliance therewith.

Background and Statutory Responsibility Change

As a background matter, at the time of the original natural gas franchise grant (i.e., 1994) Aquila's natural gas rates, terms and conditions of service were regulated by the City of Lincoln under the Municipal Natural Gas Regulation Act. Neb. Rev. Stats. §§ 19-4601 et seq. In 2003, the Municipal Natural Gas Regulation Act was repealed and replaced by the State Natural Gas Regulation Act. Neb. Rev. Stat. § 66-1801, et. seq. The purpose of the State Natural Gas Regulation Act is to transfer responsibility and jurisdiction over natural gas rates, terms, and conditions of service from Nebraska Municipalities, including Lincoln, to the Nebraska Public Service Commission. The impact on Aquila natural gas franchise in Lincoln falls into a few different areas. For example, Section 66-1804 grants the Nebraska Public Service Commission full power, authority, and jurisdiction to regulate natural gas public utilities. Section 66-1820 of the State Act provides that "no franchise ordinance involving a jurisdictional utility adopted on

or after May 31, 2003 shall include provisions contrary to or inconsistent with the State Natural Gas Regulation Act. A city shall file with the commission copies of any such franchise ordinance adopted on or after May 31, 2003, within thirty days of its passage." Neb. Rev. Stat. § 66-1820. Other sections of the State Act discuss Public Service Commission authority over Aquila's rate design methodology, customer choice programs, adequate, efficient, and reasonable natural gas service, and requirements for safety and reliability of Aquila's natural gas service. *See, e.g.,* Neb. Rev. Stats. §§ 66-1838, 66-1851, 66-1855, and 66-1856. Many safety aspects of natural gas pipeline and distribution system regulation are governed by rules and regulations of the Department of Transportation as administered by the State Fire Marshall.

Report Compliance Filing

Aquila submits this report in order to comply with its original agreement under the 1994 natural gas franchise granted by the City of Lincoln, but further acknowledges that as of 2003, the State Natural Gas Regulation Act now appears to transfer the responsibility for ensuring natural gas competition, safety, reliability, and low-cost gas service of Aquila to the Nebraska Public Service Commission. Even though the requirements set forth in Section 9 of the Lincoln franchise now appear to be preempted by the statutes found in the State Natural Gas Regulation Act, Aquila presents this report to the City to demonstrate that Aquila has assisted, is assisting, and will continue to assist the City in meeting its objectives of encouraging natural gas competition, and to ensure safe, reliable, and low-cost natural gas service within Lincoln.

In support of its compliance with the requirements of Section 9, Aquila provides the following facts, documents, and demonstration:

2. AQUILA IN LINCOLN

- Overview – Lincoln Operations
 - Employees in Lincoln
 - Customers in Lincoln
 - Gas Distribution System in Lincoln
 - Taxes Paid
- Community Involvement & Economic Development

Overview - Lincoln Operations

Employees in Lincoln:

Management & administration:	20
Sales:	4
Field Operations:	76
Customer Call Center:	71
Field Resources Center:	<u>18</u>
Total :	189

Customers in Lincoln:

Residential:	83,937
Commercial/Industrial:	<u>8,062</u>
Lincoln total:	91,999

Gas Distribution System in Lincoln:

1,110 miles of distribution main.

Automated meter reading.

Two interstate pipeline suppliers: Northern Natural Gas and NGPL.

Taxes Paid:

2004 Property taxes paid in Lancaster County:	\$609,181
2005 Motor Vehicle and Wheel Taxes:	\$32,854
2005 Franchise fees collected & paid to Lincoln:	\$2,325,202
2005 City of Lincoln sales tax collected:	\$1,205,794

Community Involvement & Economic Development:

Aquila employees participate in and contribute to numerous community service projects and civic clubs to make Lincoln a better community to live and work.

Organized activities include:

- Adopt-a-Highway/U.S. Hwy. 77
- Community Blood Bank Drive
- Food Bank Drive
- Juvenile Diabetes Research Foundation Walk-a-thon
- Junior Achievement
- Folsom Children's Zoo drive
- Lincoln Paint-a-thon
- American Cancer Society Relay for Life
- United Way

Examples of Lincoln organizations served by Aquila employees:

- City of Lincoln Building & Safety Gas Advisory Board
- Cornhusker Better Business Bureau Board
- Chamber of Commerce Board & committees
- Lincoln Energy Commission
- Plumbing, Heating & Air Conditioning Association
- Home Builders Association
- Lincoln Independent Business Association
- Lincoln Partnership for Economic Development
- Mayor's Infrastructure Finance Committee
- Neighborhood Associations
- Refrigeration Service Engineers Board
- Rotary Clubs
- Star Tran Board
- United Way
- Work Force Investment Board

Aquila also employs a full-time certified Economic Developer, who actively teams with the City, LPED, the Chamber, LES and others to grow Lincoln's existing businesses, and attract new businesses to the City.

In addition, Aquila's contributes more than \$50,000 annually in the Lincoln area to worthy organizations and provides scholarships at UNL, Union College, Nebraska Wesleyan, Doane and Southeast Community College.

3. LINCOLN MANAGEMENT STAFF

- Names, titles, phone numbers

**Aquila, Inc.
Lincoln Management Team**

Steve Pella	VP Operations	(402) 437-1725	steve.pella@aquila.com
Don Nordell	Field Operations Manager	(402) 437-1779	don.nordell@aquila.com
Alan Hersch	Customer Relations Manager	(402) 437-1865	alan.hersch@aquila.com
Mary Simmons	Economic Development Manager	(402) 437-1850	mary.simmons@aquila.com
Bret Atkins	Human Resources Manager	(402) 437-1728	bret.atkins@aquila.com
Lee Benash	Supervisor - admin & billing	(402) 437-1703	lee.benash@aquila.com
Paul Johnson	Supervisor - service	(402) 437-1772	paul.johnson@aquila.com
Lon Meyer	Supervisor - gas system	(402) 437-1761	lon.meyer@aquila.com
Dan Mechtenberg	Manager, Business Operations	(402)563-3100	dan.mechtenberg@aquila.com
Randy Paap	Manager, Engineering	(402)221-2105	randy.paap@aquila.com
Larry Headley	Manager, Regulatory Affairs	(402)221-2023	larry.headley@aquila.com
Trent Cozad	Manager, Gas Supply	(402)221-2643	trent.cozad@aquila.com

4. LINCOLN GAS DISTRIBUTION SYSTEM

- Maps
- Capital investment history



2001-2005 GROWTH AREAS

Five Year Capital Investment Review

Aquila is committed in maintaining a safe, reliable natural gas distribution system by continually investing in growth and replacement projects. In addition to the new construction and ongoing maintenance projects, Aquila has partnered with the City of Lincoln on numerous public works improvement projects. Highlights of the past five years are outlined below:

2001

- Relocate and lowered pipeline on Old Cheney between 66th & 70th Street to make way for the street widening project.
- Finalized plans to improve system serving north Lincoln.
- Relocated major feeder pipeline to clear the area for the Nebraska Heart Institute and other large commercial projects near 84th and Highway 2.

2002

- Completed several pipeline relocations during Phase 1 of the "O" street widening project from 52nd to 72nd Street; coordinated with all project participants for successful completion.
- Completed a \$1,000,000 investment in the natural gas system serving north Lincoln, to assure reliable supply for residential growth to the north, and for large customers such as ADM and Kawasaki.

2003

- Started construction on Antelope Valley project; relocated several pipelines near State Fair Park and along Vine Street, requiring significant research and planning.
- Started the 3-year project to relocate and protect the major feeder pipeline along 84th Street.

2004

- Completed work on "O" street near the intersection of 70th Street; excellent coordination with all contractors assure service was maintained to key customers, St. Elizabeth Hospital and the Veterans' Association Hospital.
- Invested several hundred thousand dollars to increase capacity of the natural gas distribution system in south Lincoln to satisfy the aggressive growth in this area.
- Completed an upgrade to the distribution system in NE Lincoln to support the growth along 84th street.

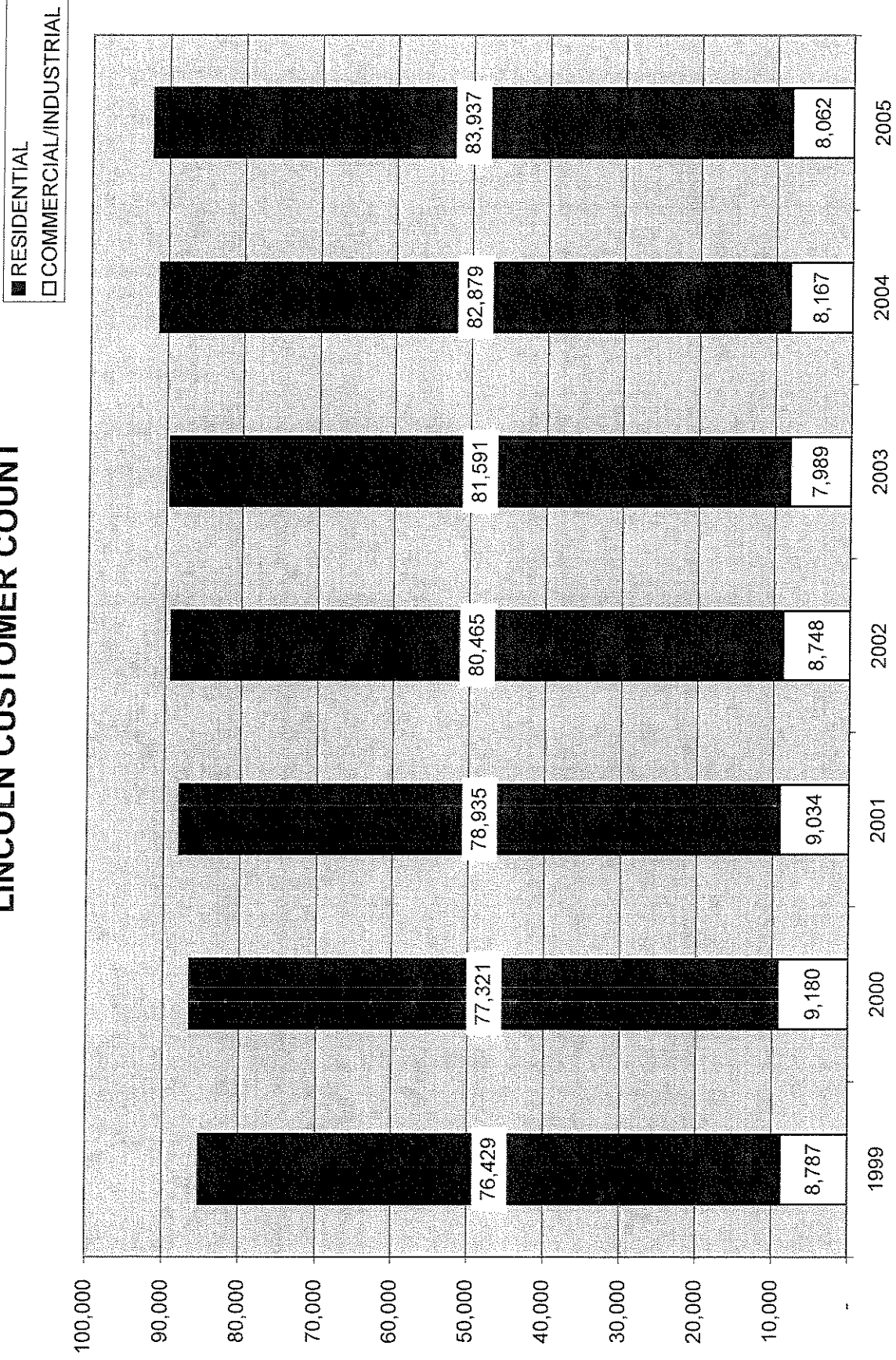
2005

- Completed pipeline relocation work on the final phase of the 84th street project; closely coordinated with the other utilities to eliminate delays in the overall road completion schedule.
- Upgraded the distribution system in NW Lincoln to support the continued growth along the NW 48th Street corridor.
- Started a multi-year program to replace service line risers to avoid future problems; investing more than \$1,000,000 to improve the safety and reliability of the system.

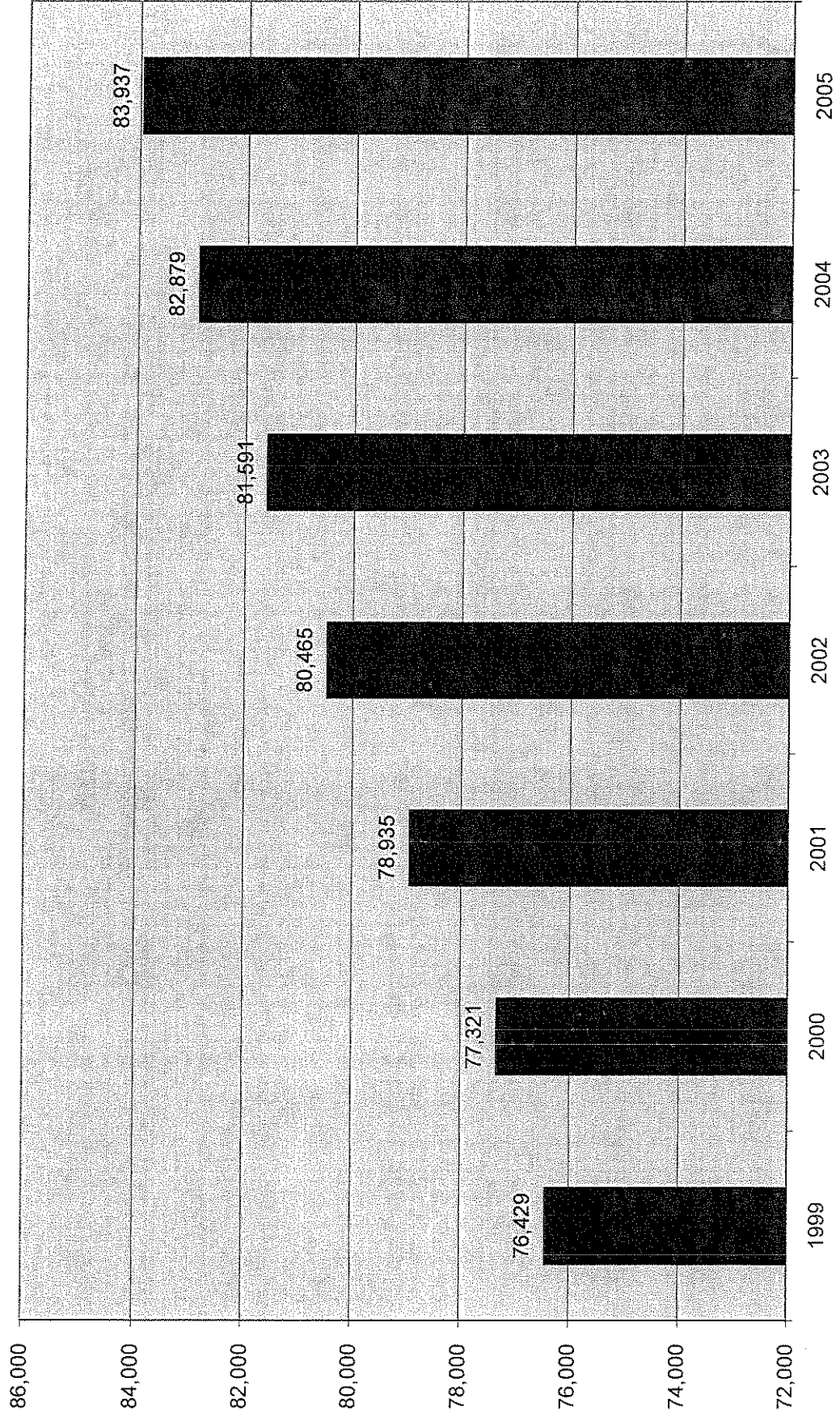
5. LINCOLN CUSTOMERS BY CATEGORY

- Table: residential, commercial, industrial, 2001-2005

LINCOLN CUSTOMER COUNT



RESIDENTIAL



	COMMERCIAL/INDUSTRIAL	RESIDENTIAL
1999	8,787	76,429
2000	9,180	77,321
2001	9,034	78,935
2002	8,748	80,465
2003	7,989	81,591
2004	8,167	82,879
2005	8,062	83,937

6. RESPONSE TO FRANCHISE REQUIREMENTS

- Encourage competition
 - Open system for transportation
 - BEO
 - LV Transport
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 - Safety, emergency response, outages
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COMPETITION

Commercial and Industrial

Competition among alternate natural gas suppliers is alive and well in the Lincoln market. More than 40 percent of the total gas used in the Lincoln is supplied by marketers other than Aquila (see chart below).

Every commercial and industrial customer can choose to purchase its natural gas commodity supply from a certified natural gas provider (CNGP). Seven gas marketers are currently certified by the Nebraska Public Service Commission to provide gas commodity supplies in the state.

Aquila provides local gas transportation and billing services for customers choosing to buy their gas supply from an alternate marketer. Today, Aquila transports gas supplies for 34 of the large industrial customers and 1760 smaller commercial customers in the City.

See "Alternate Gas Supplies - Lincoln" Chart

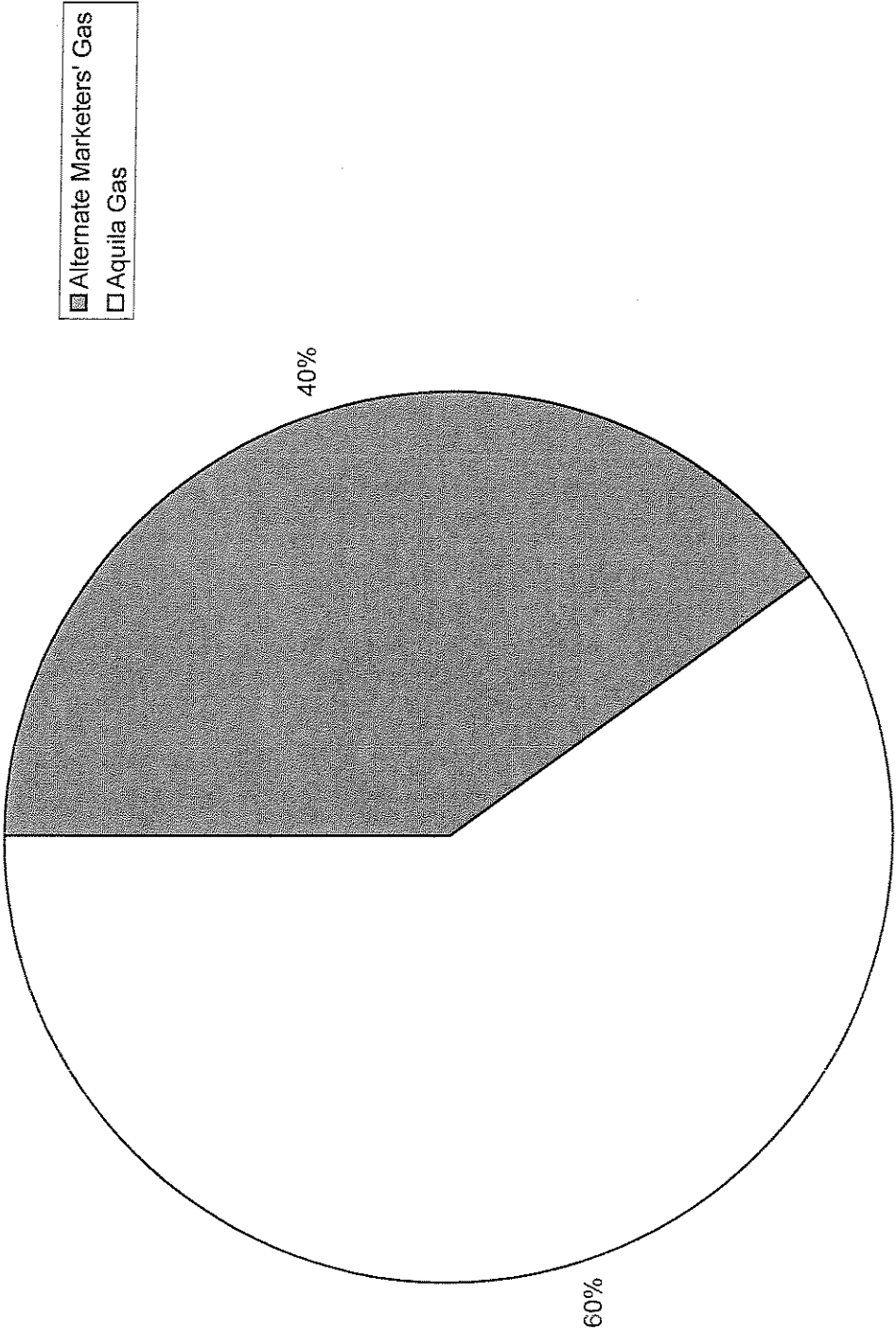
The "Lincoln Energy Options Program" charts that follow set out graphically the steady increase of competition in Lincoln. Competition of gas supply in Lincoln's business and commercial sector is alive and well.

Residential

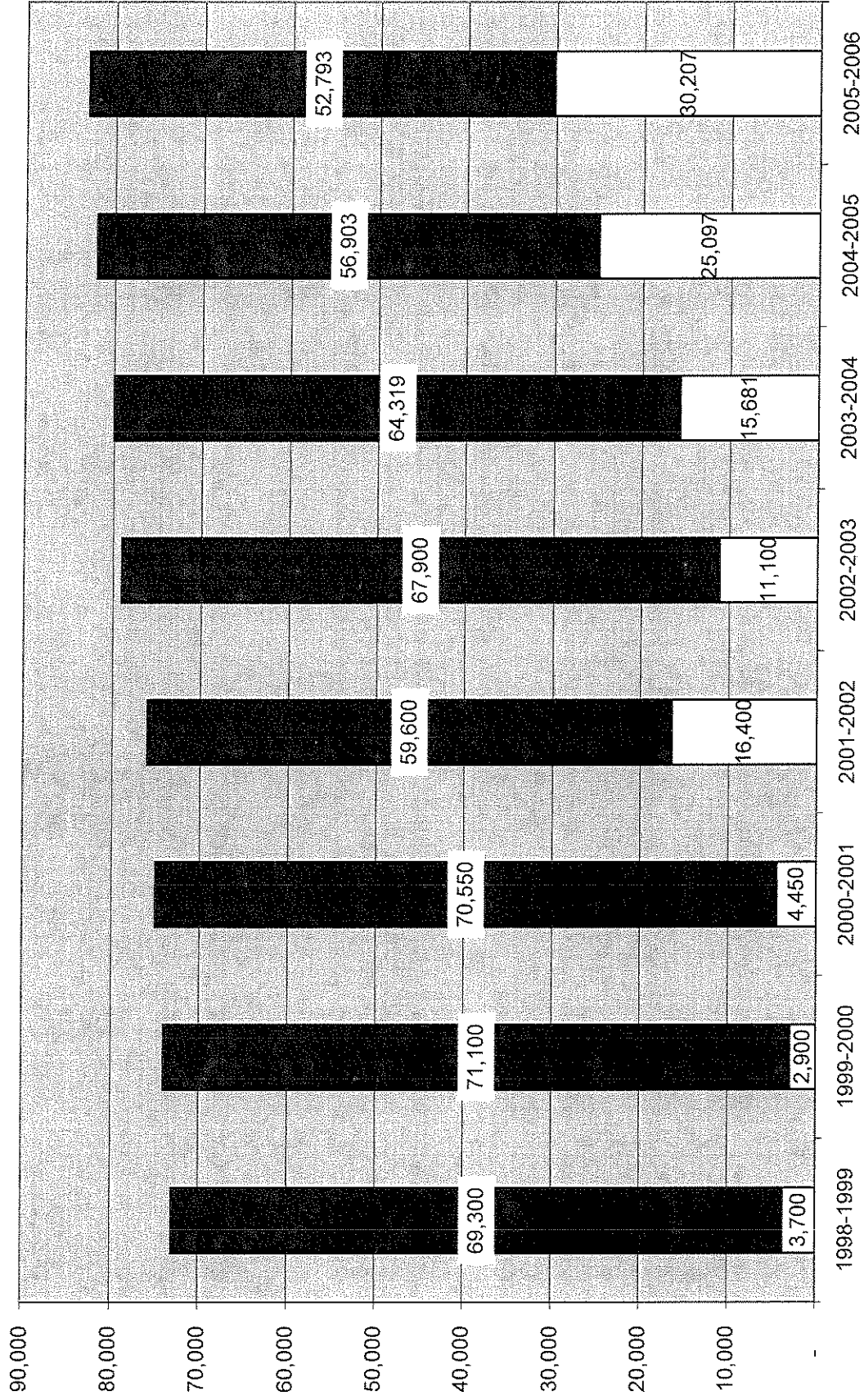
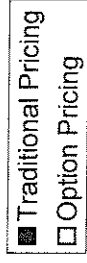
In addition to alternate supplies for its commercial customers, Lincoln's residential customers may choose among price options.

Aquila has offered its residential customers either a fixed annual price or traditional sales service pricing since 1998. This year over 30,000 residential customers enrolled in this successful program.

ALTERNATE GAS SUPPLIES - LINCOLN



LINCOLN ENERGY OPTIONS



Program Year	Option Pricing	Traditional Pricing	Total Residential Customers
1998-1999	3,700	69,300	73,000
1999-2000	2,900	71,100	74,000
2000-2001	4,450	70,550	75,000
2001-2002	16,400	59,600	77,000
2002-2003	11,100	67,900	79,000
2003-2004	15,681	64,319	80,000
2004-2005	25,097	56,903	82,000
2005-2006	30,207	52,793	83,000

Safety & Reliability

Aquila is proud of its track record in providing safe, reliable natural gas service to customers in Lincoln. Aquila continues to meet and exceed industry standards for gas distribution system maintenance. Trained personnel perform numerous annual, monthly, and weekly maintenance activities that assure dependable service. Some key pipeline safety activities undertaken by Aquila personnel and inspected by the Nebraska State Fire Marshal's Division of Pipeline Safety include:

- Annual Business District leak surveys
- Annual leak surveys on all gas mains & services
- Annual inspection of emergency valves
- Annual district regulator station inspections
- Annual Public Official safety training
- Weekly odorant usage reports and monthly odorant intensity tests
- Daily monitoring of the system performance
- Cathodic protection on steel sections of our distribution system
- Communication of public safety information
- Emergency response performance
- Department of Transportation Operator Qualification training records
- System performance and leak history
- Proper meter and regulator installation standards

In addition, Aquila is a member of the State One-Call system which manages the excavators' requests for locating all utility lines. During 2005, Aquila performed over 89,000 line locates which has steadily increased since the inception of the one-call legislation in 1994.

Aquila maintains an outstanding emergency response rate while responding to customer gas odor complaints. During the past two years, Aquila maintained a 99.77% response rate within 60 minutes while responding to over 8,400 odor complaints.

Aquila personnel work closely with the Lincoln Public Works Department while maintaining its distribution system in the city's right-of-ways. In combination to our own safety rules, Aquila follows all City of Lincoln Construction Standards and Traffic Control Rules to ensure public safety.

LOW COST SERVICE

Customers' gas bills are comprised of two parts: Distribution Cost and Gas Cost. Distribution costs are the costs for Aquila to build and operate the gas distribution system. Gas cost is the actual natural gas molecules flowing through the system to customers' appliances. Aquila works hard to manage both parts of the gas bill in order to provide Lincoln customers with safe, reliable service at reasonable rates.

DISTRIBUTION COST MANAGEMENT

Examples of processes to keep Distribution Costs low are:

- a centralized Call Center in Lincoln which takes calls from gas customers in 5 states, with shared costs;
- a centralized Field Resource Center in Lincoln to dispatch service and operations employees in 5 states, with shared costs;
- Service vans equipped with Mobile data Terminals for efficient management of employee time and travel;
- automated meter reading using a radio telemetry and a van equipped with a computer for drive-around meter reading, avoiding costly manual reads;

GAS COST MANAGEMENT

Aquila also manages its Gas Costs to balance price with reliability. Gas supply professionals use a “portfolio approach” to manage gas supplies. The portfolio is comprised of three parts:

- 40% Fixed products (fixed price and gas storage);
- 30% Index products (seasonal, monthly and daily); and
- 30% Option products (caps and collars).

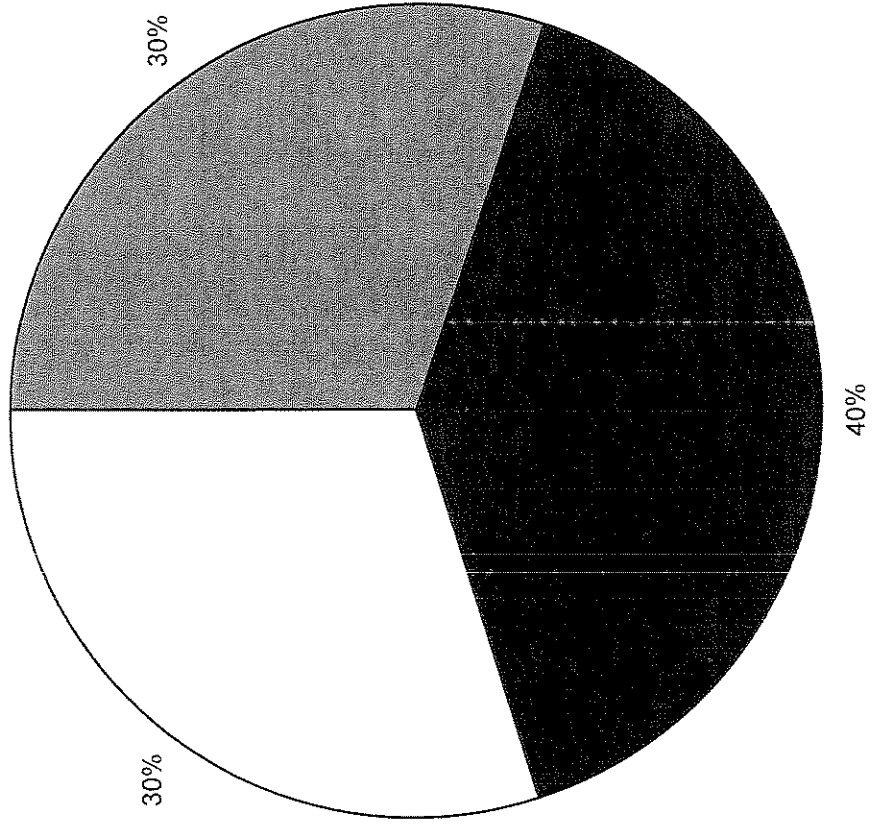
See “Portfolio Mix” Pie Chart

This managed mix of gas supplies reduces price volatility, promotes price stability and provides operational flexibility. With this mix in place 2 of the 3 portfolio parts are working in the customers’ favor, whether prices are rising or falling.

Through these practices, Aquila’s distribution rate for residential service in Lincoln is among the lowest in the region (see chart below). Note that these rates are for utility distribution costs, and do not include gas costs.

See “Gas Distribution Rates – Midwest Cities” Chart

PORTFOLIO MIX



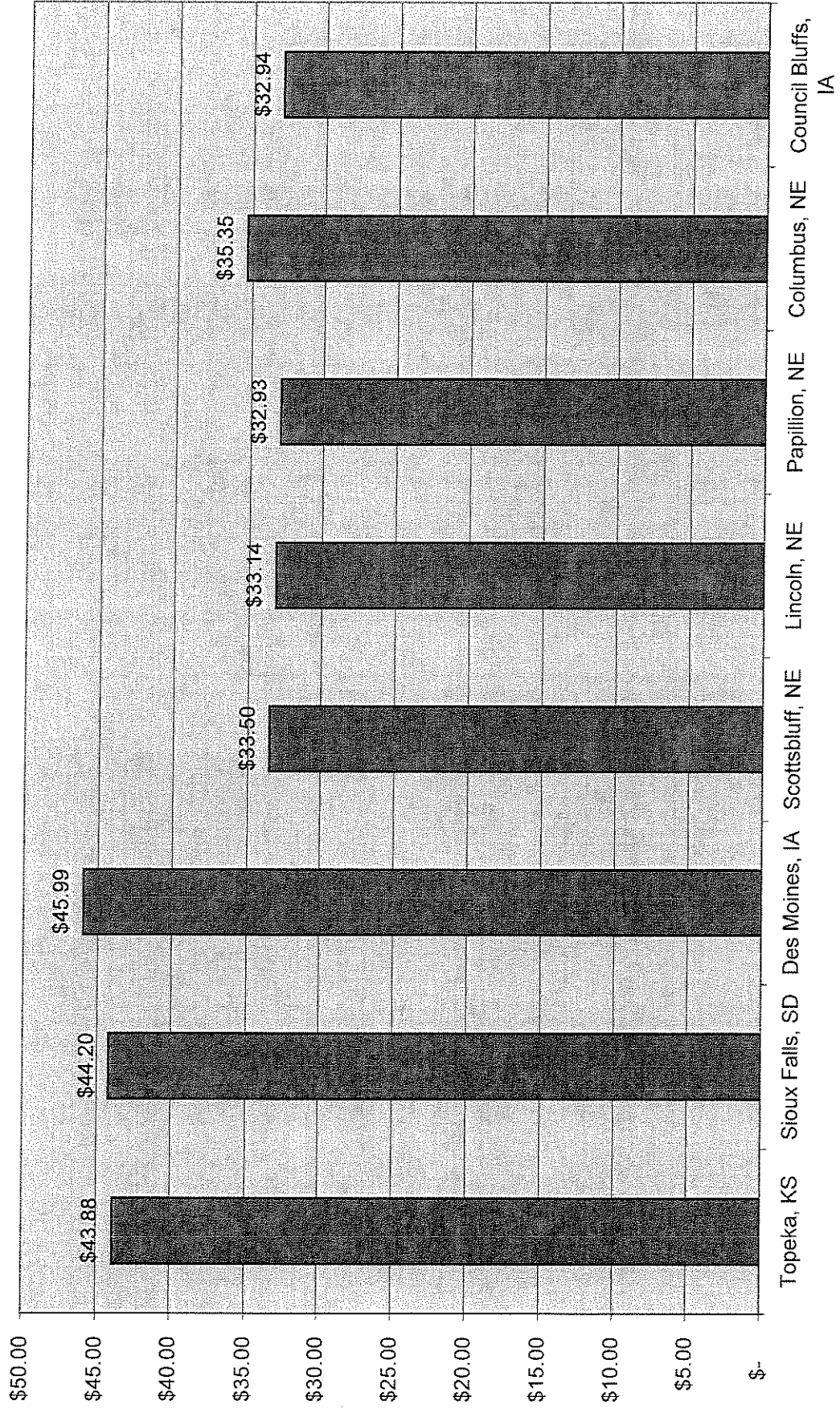
- Index Products (Term, Monthly, Daily)
- Fixed Products (Fixed price, Storage)
- Option Products (Calls, Collars)

Gas Distribution Rates - Midwest Cities

<u>City</u>	<u>Gas Distributor</u>	<u>Customer Charge (per month)</u>	<u>Rate Steps</u>	<u>Distribution rate (per therm)</u>	<u>Distribution Cost - (200 therms)</u>	<u>% Difference to Lincoln</u>
Topeka, KS	Kansas Gas Service	\$8.95	All volumes	\$0.174650	\$43.88	32%
Sioux Falls, SD	MidAmerican	\$8.00	First 250/mo. Balance	\$0.181000	\$44.20	33%
Des Moines, IA	MidAmerican	\$10.00	First 250/mo. Balance	\$0.179930 \$0.095080	\$45.99	39%
Scottsbluff, NE	Kinder Morgan	\$5.00	First 10/mo. Next 40 Next 450	\$0.278786 \$0.253786 \$0.103751	\$33.50	1%
Lincoln, NE	Aquila	\$11.00	All volumes	\$0.110700	\$33.14	0
Papillion, NE	Aquila	\$11.00	All volumes	\$0.109670	\$32.93	-1%
Columbus, NE	Aquila	\$11.00	All volumes	\$0.121770	\$35.35	7%
Council Bluffs, IA	Aquila	\$9.20	All volumes	\$0.118680	\$32.94	-1%

Note: Customers' bills include gas commodity costs, which are added to distribution costs

GAS DISTRIBUTION COST BY CITY December 2005



7. FINDING/RECOMMENDATION

- Findings - related to franchise language
- Recommendation: Council and Mayor extend Aquila franchise 8 years

7. FINDING/RECOMMENDATION

The facts and documents presented in this report demonstrate that Aquila has assisted the City in meeting its objectives of encouraging natural gas competition and ensuring safe, reliable, and low-cost natural gas service to its residents.

All of Aquila's customers in Lincoln have either supply choice or price selection options. Commercial and Industrial customers located in Lincoln can choose from a variety of natural gas suppliers from whom they may purchase their natural gas supply. Residential customers are permitted an opportunity to choose either a fixed price or variable natural gas commodity rate from Aquila.

As shown in the report above, Aquila has taken significant steps to maintain its natural gas distribution system. It invests a significant amount of money in operating, maintaining, and growing its system in the Lincoln area. Aquila has maintained a multi-state Call Center and Dispatch Center in Lincoln for several years. This service and operation center brings more than 100 jobs to the City of Lincoln.

Aquila's anticipates that its compliance with Section 9 of the natural gas franchise will lead the City to extend the term of its existing franchise for an additional eight (8) years commencing on January 1, 2007 to December 31, 2014. Aquila respectfully requests and recommends that the City extend its franchise to December 31, 2014.